The Whole Picture: Building Better Portfolios With Public and Private Real Asset Debt

Institutional investors' fixed-income portfolios often include exposures to traditional, lower-yielding public products—such as government bonds and investment-grade bonds—for their stability and liquidity benefits. In addition, when seeking to improve fixed-income portfolio returns and diversification, institutional investors often turn to higher-yielding private direct lending funds.

However, we believe having an allocation to public high-yield debt—with a focus on real assets—is another potential solution to consider as institutions look to enhance their fixed-income portfolios. We believe an allocation to real asset high yield, coupled with private debt and lower-yielding public product allocations, can provide potential portfolio benefits, including better credit quality, lower overall default risk, less interest rate sensitivity, greater sector diversification, and improved returns across different points in the economic cycle.

POTENTIAL BENEFITS OF A COMBINED APPROACH

Improved Credit Quality

We find that exposure to public high yield, and real asset high yield in particular, can help improve a fixed income portfolio's credit quality.

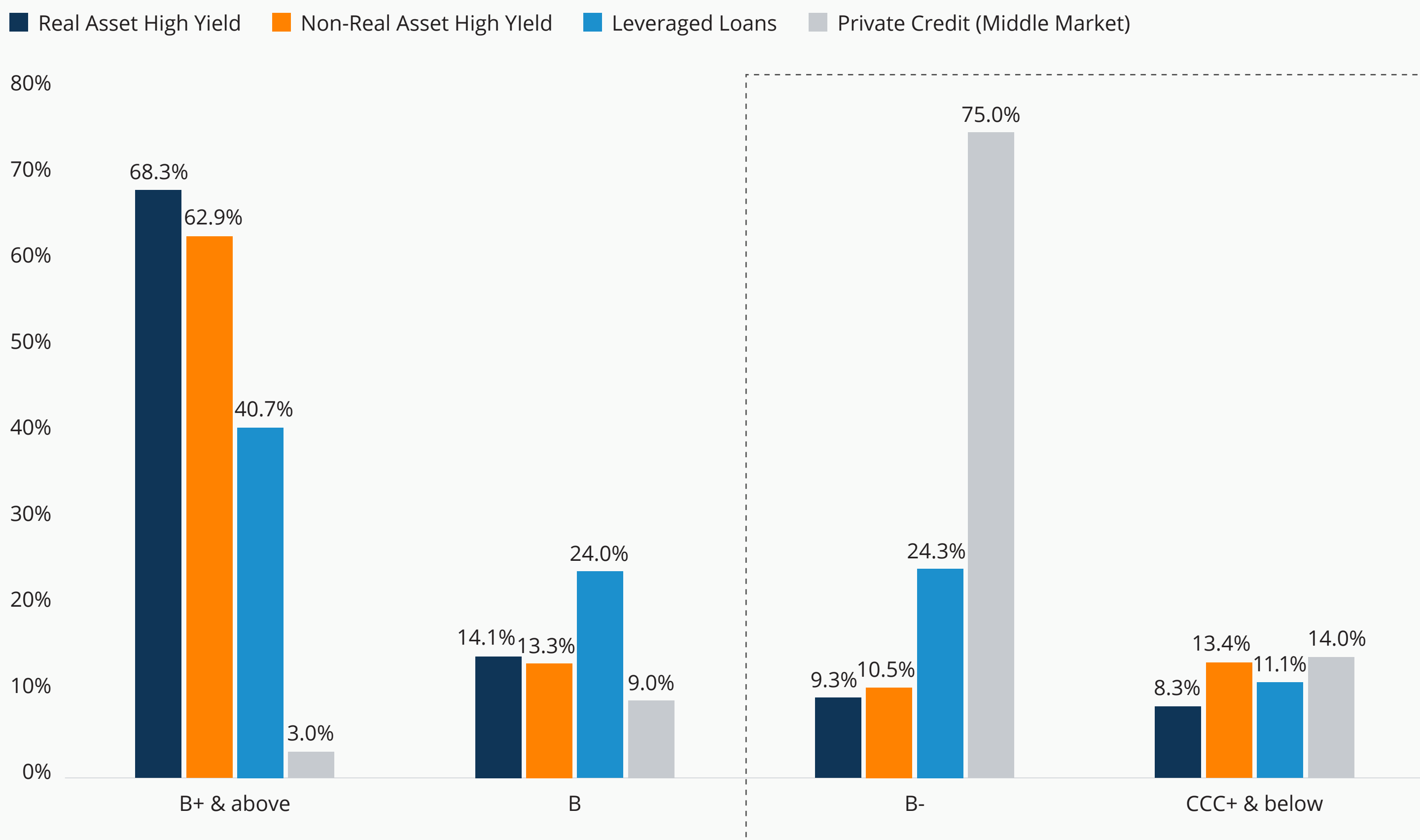
Rating agencies typically rate public debt issuance. These ratings provide investors with an indication of the credit quality of their investment, helping them assess if potential returns are commensurate with risk. However, debt issued to a borrowing company in the private debt market is typically not rated, unless rating agencies are asked to issue credit estimates for the company in question.

According to S&P Global Research, the borrowers in the private debt universe tend to be smaller companies with less straightforward balance sheets, more complex business models or speculative growth trajectories. A sample of credit estimates provided by S&P Global Research for private debt borrowers shows that these companies are typically concentrated at a lower end of the credit spectrum vs. public high yield ratings broadly.

As of the end of the third quarter of 2023, close to 90% of private credit estimates were B- or lower, including nearly 14% that were CCC+ or below. In comparison, only 17.6% of U.S. real asset high yield issuers were rated B- or lower.

CREDIT QUALITY IS HIGHER WITHIN REAL ASSET HIGH YIELD

% Market Value by Credit Quality



B- default rate is *4x greater* than B+[2]

As of September 30, 2023. Source: Bloomberg, ICE BofA, LCD, S&P Global Ratings. Real Asset U.S. High Yield is represented by the real asset sectors, as defined by Brookfield, of the ICE BofA U.S. High Yield Index. Non-Real Asset U.S. High Yield is represented by the non-real asset sectors, as defined by Brookfield, of the ICE BofA U.S. High Yield Index. Leveraged Loans are represented by the Morningstar LSTA US Leveraged Loan Index. Credit (Middle Market) is represented by Middle Market Credit Estimates, which cover all outstanding S&P Global Ratings U.S. credit estimates, including estimates for obligors not currently held within a CLO transaction. CLO stands for collateralized loan obligation. Default rate data are based on the S&P median one-year default rates (1981-2022). See disclosures for index definitions. Indexes are unmanaged and it is not possible to invest directly in an index. Index performance is shown for illustrative purposes only and does not predict or depict the performance of any investment. Past performance is not indicative of future results.

Within the public speculative-grade market, meanwhile, we find that real asset companies are generally higher-quality businesses compared with non-real asset companies. This is due to the unique characteristics of real asset businesses. These businesses are backed by long-lived assets that tend to appreciate over time, offer strong collateral, face more limited competition, have less economic sensitivity, and deliver relatively stable cash flows. Non-real asset companies, meanwhile, may face more intense competition because of fewer barriers to entry.

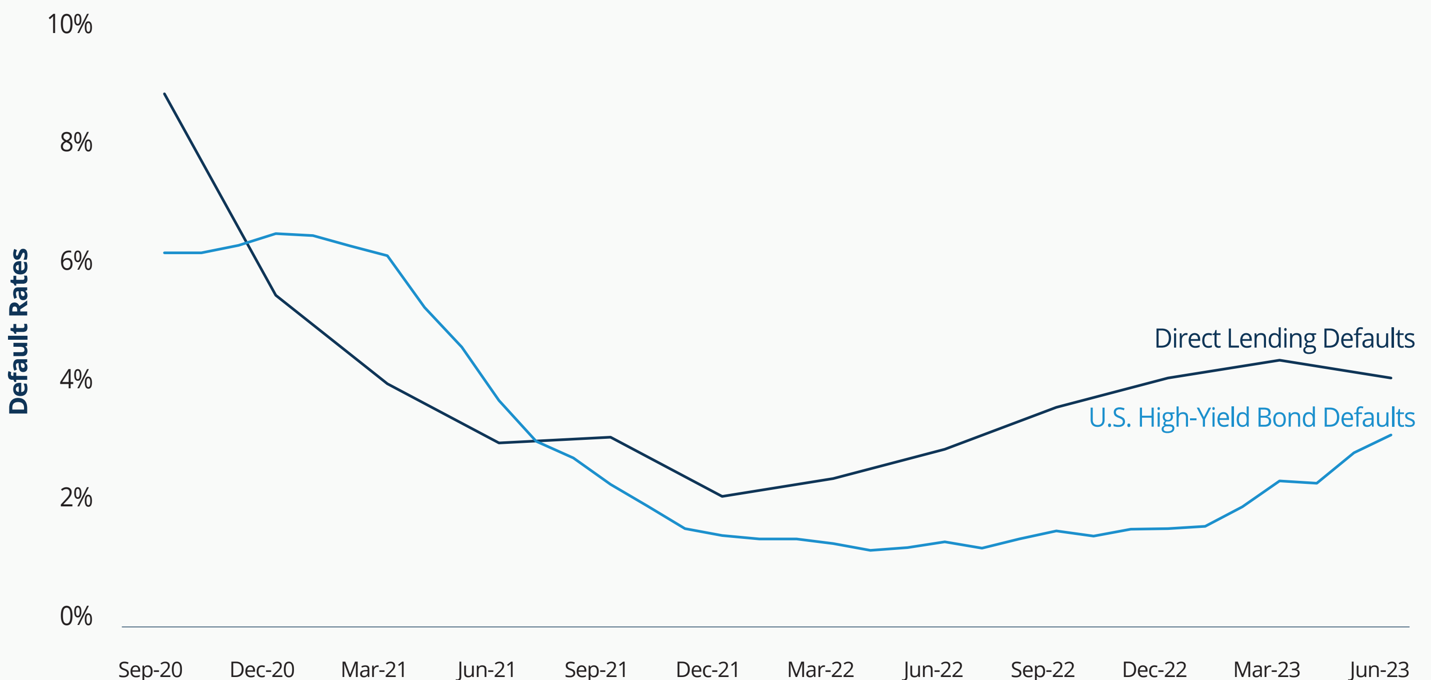
As a result, real asset high yield currently has better credit quality than other areas in the leveraged finance universe. Listed real asset U.S. high yield has a higher concentration in the B+/BB credit rating category (at over 82%) than non-real asset U.S. high yield and leveraged loans. In contrast, non-real asset sectors have significantly more low-rated B and CCC rated exposure, as highlighted in the chart above.

Lower Defaults

In private debt markets, since the borrowing entities are often privately owned, the health of borrowers' balance sheets is not publicly disclosed. However, private debt lenders can perform thorough due diligence on the borrowing companies. They also can put in place appropriate covenants to monitor the performance of these companies on an ongoing basis, with the option to intervene in periods of underperformance or restrict the company from taking on additional debt.

If the financial health of the borrowing company is stressed or distressed, private debt issuers and lenders have several levers to pull to avoid a default, without public purview. These include, but are not limited to, easing covenants, pausing interest payments, negotiating to receive payment-in-kind, or extending principal maturities. In contrast, public debt is usually held in companies where information is shared openly, and default statistics are publicly maintained.

DEFAULT RATES VARY OVER THE CREDIT CYCLE



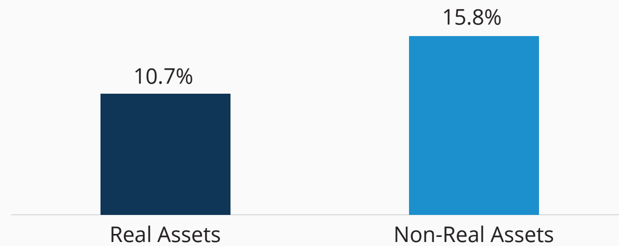
As of June 30, 2023. Source: Lincoln International, S&P Global Ratings U.S. High-Yield Bond Defaults.

Since the beginning of 2022, default rates have been trending higher across both public and private debt, as shown in the chart above. During the COVID pandemic, private credit lenders were able to pre-empt defaults by intervening earlier and taking measures to avoid immediate distress. However, companies that were unable to self-correct following the pandemic eventually defaulted, leading to a rise in defaults within private lending.

In contrast, the high yield industry witnessed more defaults during the pandemic. Since then, high yield defaults have fallen, as the bulk of bad credit had been dealt with earlier. While high yield defaults, and real asset high yield defaults in particular, are currently lower than private credit defaults, both private credit and public credit go through varying cycles of defaults, so including exposure to both may help optimize a portfolio's default exposure overall.

WITHIN THE HIGH YIELD UNIVERSE, REAL ASSET SECTORS HAVE EXHIBITED LOWER DEFAULT, AND HIGHER RECOVERY, RATES

10-YEAR ROLLING AVERAGE CUMULATIVE DEFAULT RATE IN YEAR 10[1] (1970-2022)



AVERAGE RECOVERY RATES[2]

	High-Yield Bonds	Loans
Real Assets[3]	**40.5%**	**56.1%**
Non-Real Assets	37.0%	50.1%

[1] Source: Moody's, Brookfield PSG research. Default rates reported from 1970-2022.

[2] Source: J.P. Morgan High Yield and Leveraged Loan Research Report, June 9, 2023, and Brookfield PSG research. Recovery rates are reported from 2008-2023. Bond recovery rates represent the weighted average price of all bonds in the capital structure 30 days after default, weighted by total debt. Data shown do not represent the performance of any Brookfield composite or investment product. Past performance is not indicative of future results and there can be no assurance past trends will continue in the future. See disclosures for additional information.

[3] Brookfield classifies the following sectors as real asset debt: cable & satellites; chemicals; energy; gaming, lodging & leisure; housing; metals & mining; telecommunications; transportation; and utilities.

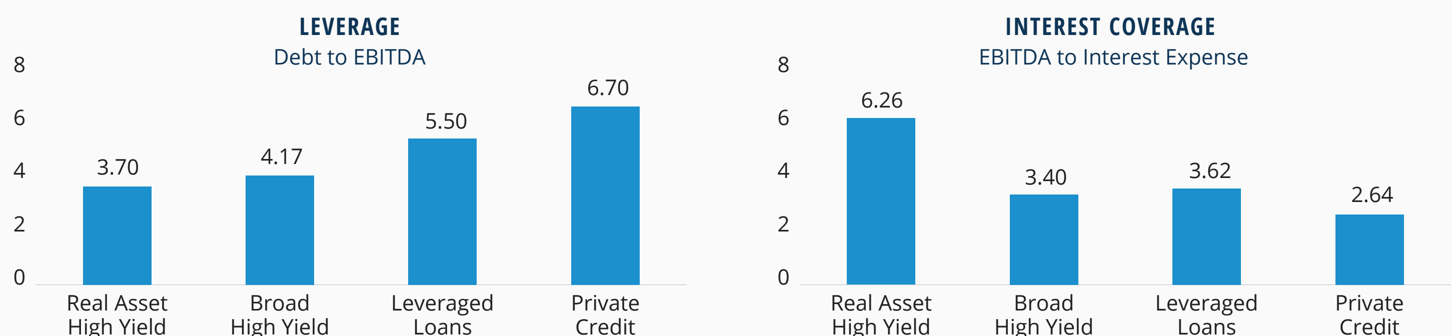
Within high yield, higher-rated debt (i.e., B+ rated and above), which is more prevalent in real asset sectors, has historically had meaningfully lower default rates compared with lower-quality high-yield debt. In addition, real asset high yield has had higher recovery rates than broad high yield.

Less Interest Rate Sensitivity

One key difference between private credit and public debt is how interest is charged on any issued debt. In private credit, the interest rate is predominately a floating rate, i.e., if interest rates increase, so too does the interest expense. For public high-yield bonds, the interest rate is a fixed rate set at the time of debt issuance.

Prior to 2022, interest rates had remained low for several years, allowing companies to increase leverage inexpensively, whether through the public or private markets. However, the credit landscape has completely shifted since 2022, as central banks globally have raised interest rates in an effort to tame high inflation. Consequently, the floating rate interest burden has grown for companies that have private debt. As shown in the chart below, companies with private credit tend to be more levered. In addition, in the current interest rate environment, they also tend to have lower interest coverage ratios than companies with public debt. Moreover, within public high yield, real asset debt sectors have stronger credit fundamentals than broad high yield.

CREDIT FUNDAMENTALS REMAIN STRONG WITHIN REAL ASSETS



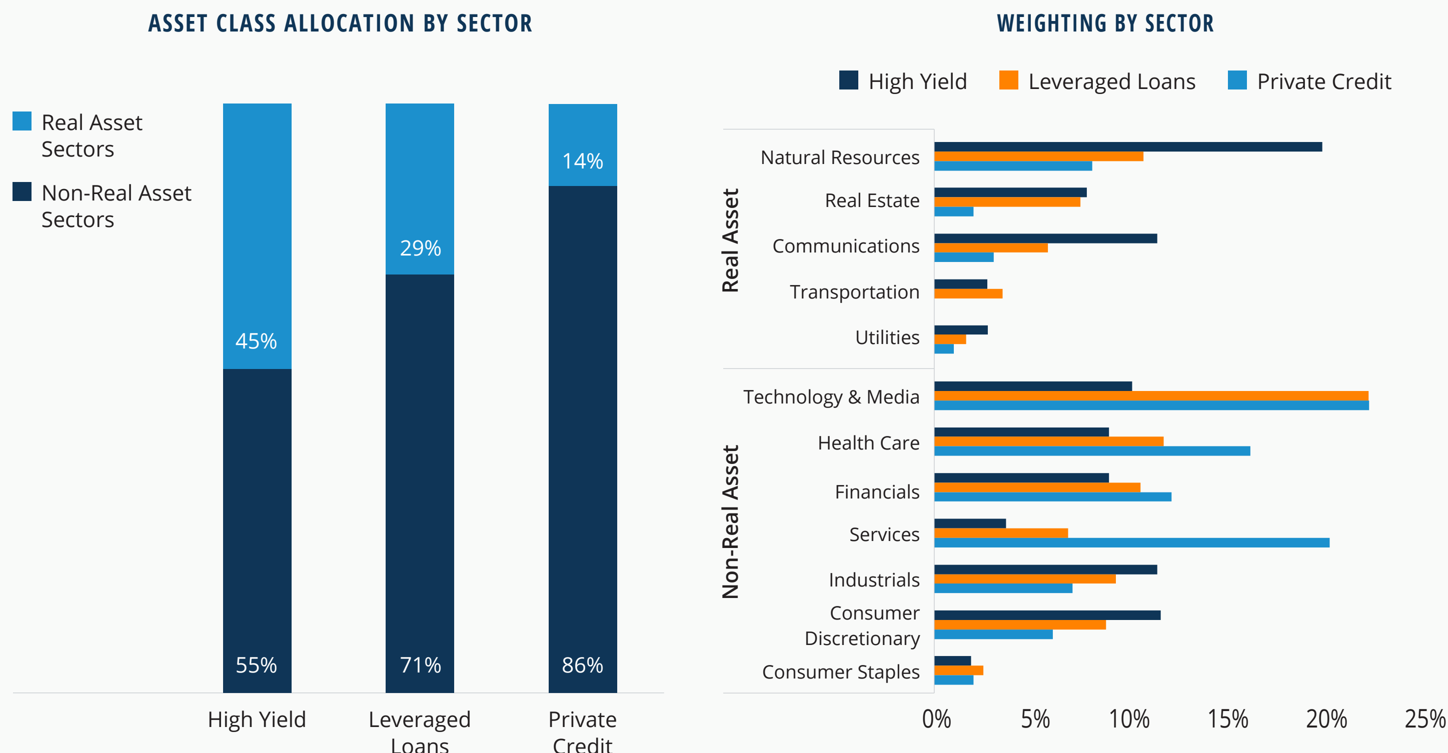
As of Q2 2023. Public Credit Source: Brookfield Public Securities Group LLC analysis of J.P. Morgan Credit Research.

Private Credit Source: Middle Market ($50 million of EBITDA or less) as defined by Pitchbook LCD. EBITDA refers to earnings before interest, taxes, depreciation and amortization.

Greater Sector Diversification

High yield and private credit have complementary sector exposures, so including both can potentially offer diversification benefits to a portfolio. Within high yield, almost half of issuers are real asset debt companies, vs. only 14% in private credit. Meanwhile, private credit can offer greater exposure to other sectors, such as health care, services and technology & media.

HIGH YIELD AND PRIVATE CREDIT HAVE COMPLEMENTARY SECTOR EXPOSURES



As of September 30, 2023. Source: Brookfield PSG analysis of Bloomberg and Morningstar data. High Yield is represented by the ICE BofA U.S. High Yield Index. Leveraged Loans are represented by the Morningstar LSTA US Leveraged Loan Index. Private Credit is represented by the Cliffwater Direct Lending Index. See disclosures for index definitions. Indexes are unmanaged and it is not possible to invest directly in an index. Index performance is shown for illustrative purposes only and does not predict or depict the performance of any investment. Past performance is not indicative of future results.

Diversification does not guarantee a profit or protect against loss.

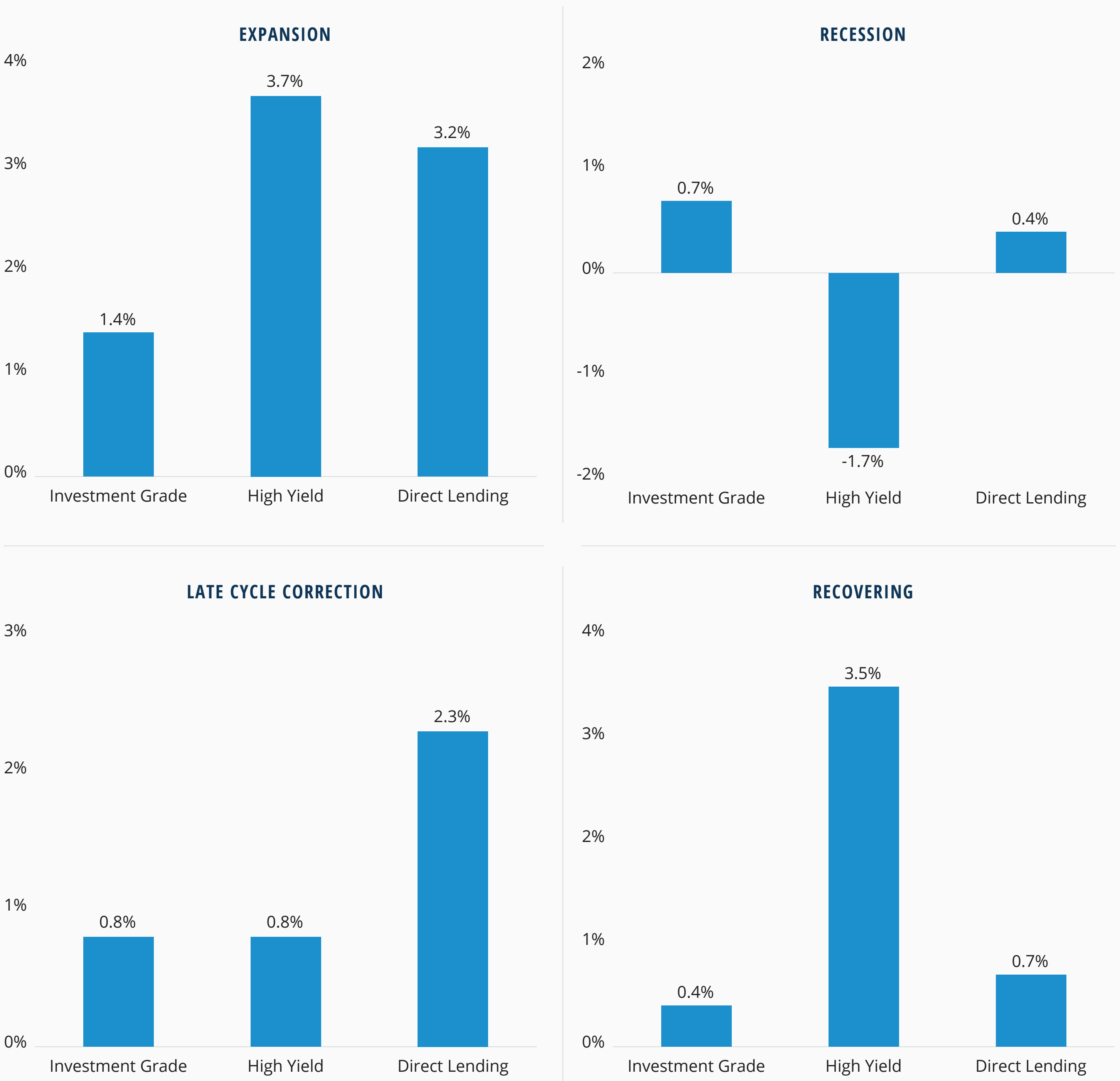
Enhanced Returns Across the Economic Cycle

In order to enhance returns within a debt portfolio over the longer term, we believe investors should consider incorporating high yield along with lower-yielding public debt exposures and private direct lending allocations.

Government and investment-grade bonds are critical for their liquidity and preservation of capital during down markets, while U.S. private debt historically has performed well when economic growth has peaked. At the same time, exposure to public high-yield debt can potentially enhance return profiles during different points in the economic cycle. We find that U.S. high yield has historically provided equal, if not better, risk-adjusted returns than private lending in expanding and recovering economic environments.

PUBLIC HIGH YIELD AND PRIVATE CREDIT HAVE COMPLEMENTARY RETURNS ACROSS THE ECONOMIC CYCLE

Average Returns During Economic Cycle Stages (December 31, 2004-September 30, 2023)



As of September 30, 2023. Source: Brookfield Public Securities Group LLC (PSG) analysis of Bloomberg and Institute for Supply Management (ISM) data. Economic cycle stages defined by ISM Purchasing Managers Index (PMI), a diffusion index summarizing economic activity in the manufacturing sector in the U.S. A PMI Index reading above 50 and increasing indicates that the manufacturing economy is generally expanding; above 50 and decreasing indicates that the manufacturing economy has peaked and is cooling; below 50 and decreasing indicates that the manufacturing economy is generally declining; and below 50 and increasing indicates that the manufacturing economy is recovering. Investment Grade is represented by the ICE BofA U.S. Investment Grade Index. High Yield is represented by the ICE BofA U.S. High Yield Index. Direct Lending is represented by the Cliffwater Direct Lending Index. See disclosures for index definitions. It is not possible to invest directly in an index. Index performance is shown for illustrative purposes only and does not predict or depict the performance of any investment. Past performance is not indicative of future results.

ACCESSING THE OPPORTUNITY

We believe a fixed-income investing approach that includes private direct lending, lower-yielding public debt, and real asset high yield can provide potential portfolio benefits in addition to the obvious benefit of increased liquidity. These benefits include improved credit quality, lower defaults, less interest rate sensitivity, greater sector diversification, and enhanced returns across economic cycles.

To access this opportunity, security selection and the credit quality of underlying entities matter. Competition for deals in the private debt market has significantly increased in recent years amid all-time high dry powder—and so too has aggressive underwriting. This means it's key to work with a manager who has robust due diligence processes, has a history of consistent returns, and will not place deployment of capital ahead of deal quality.

Within the public debt market, experience in real assets is paramount to capture the opportunity we see in real asset high yield. At Brookfield, we have this deep expertise, having invested in public and private debt across multiple market cycles. We employ an active approach rooted in superior fundamental and credit analysis, aiming to add value through our security selection, sector allocations and credit allocations.

RISK DISCLOSURES

All investing involves risk. The value of an investment will fluctuate over time, and an investor may gain or lose money, or the entire investment. Real assets include real estate securities, infrastructure securities and natural resources securities.

Fixed income risks include interest-rate and credit risk. Typically, when interest rates rise, there is a corresponding decline in bond values. Credit risk refers to the possibility that the bond issuer will not be able to make principal and interest payments.

CREDIT RATING

Bond ratings are grades given to bonds that indicate their credit quality as determined by private independent rating services such as Standard & Poor's, Moody's and Fitch. These firm evaluate a bond issuer's financial strength or its ability to pay a bond's principal and interest in a timely fashion. Ratings are expressed as letters ranging from 'AAA', which is the highest grade, to 'D', which is the lowest grade. Credit ratings are subject to change.

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The Cliffwater Direct Lending Index (CDLI) seeks to measure the unlevered, gross of fees performance of U.S. middle market corporate loans, as represented by the underlying assets of Business Development Companies (BDCs), including both exchange-traded and unlisted BDCs, subject to certain Eligibility Criteria. The CDLI is an asset-weighted index that is calculated on a quarterly basis using financial statements and other information contained in the U.S. Securities and Exchange Commission (SEC) filings of all eligible BDCs.

The ICE BofA U.S. High Yield Index tracks the performance of U.S. dollar-denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market.

The ICE BofA U.S. Corporate Index tracks the performance of U.S. dollar-denominated investment-grade corporate debt publicly issued in the U.S. domestic market.

The Morningstar LSTA US Leveraged Loan Index tracks the performance of more than 1,400 U.S. dollar-denominated loans, deriving its constituents from syndicated term leveraged loans (also known as bank loans or senior secured loans) that are held within top-tier institutional investor loan portfolios tracked by PitchBook and LCD.

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